"RULES OF ENGAGEMENT FOR ROUGH TIMES: FEDERAL-STATE RELATIONSHIPS"

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To Have a Good Relationship, You Need to Know Your Partner

- As we know, state budgets are strained. Can the federal government solve the problems (or at least contribute to a solution)?
  - It seems (at the risk of understatement), unlikely.
  - In the longer run, the answer is perhaps "possibly."
- The fiscal condition of the U.S. government.
  - The deficit in FY2009 was $1.4 trillion, or 10 percent of GDP. This is the largest percentage since the end of WW II.
    - At least five factors play a role: increases in defense spending (associated with wars in Iraq and Afghanistan); tax cuts in 2001 and 2003; the ARRA (recovery act); the recession (12/07-6/09); and TARP and Fannie/Freddie costs.
    - Short-run (current) deficits are *not* (and should not) be viewed as a central economic concern.
      - Deficits in a weak economy are almost surely helpful.

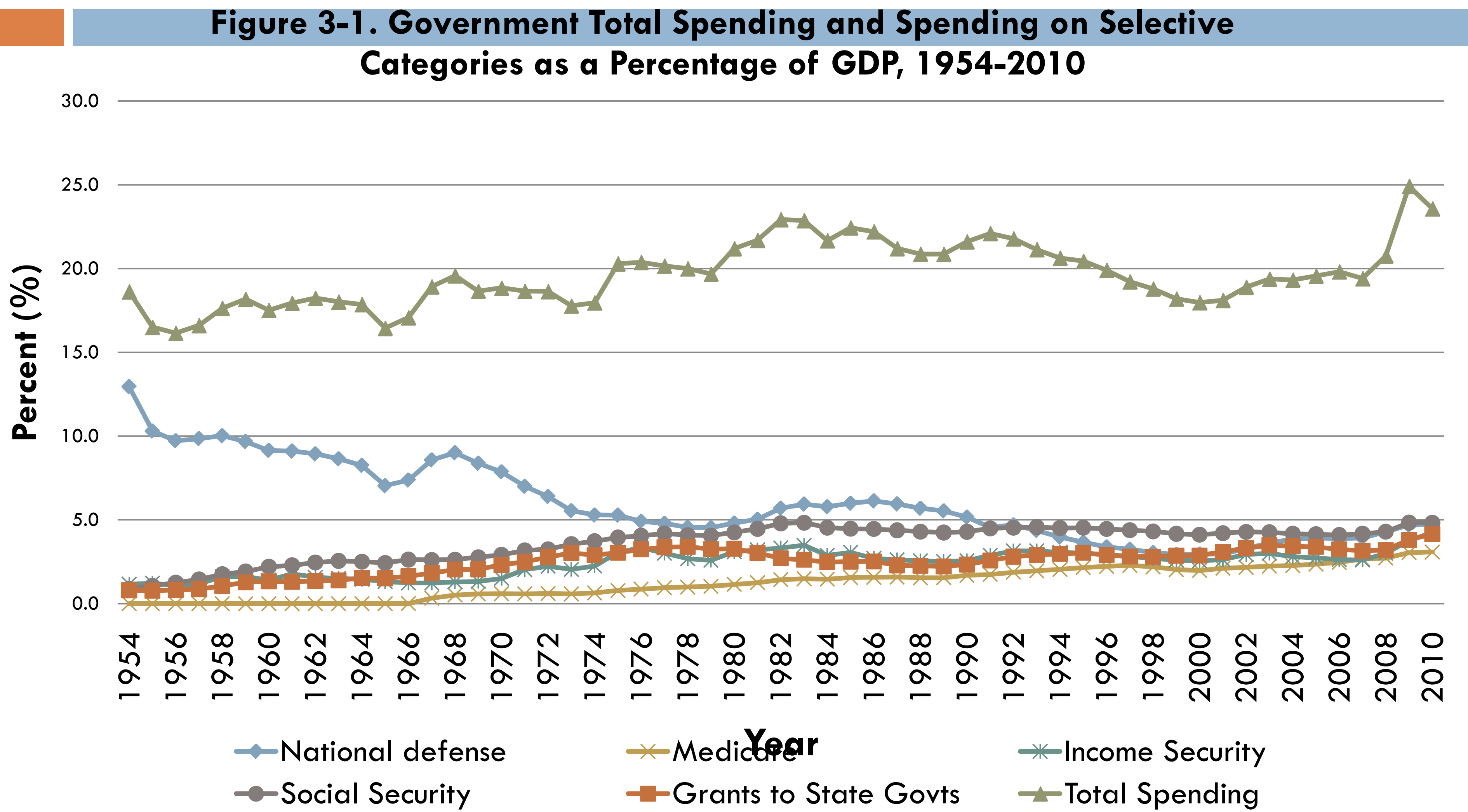
The 900 Pound Gorilla in Federal-State Relations

- The medium- and long-run fiscal situation is dire.
  - Auerbach and Gale (2011) show under reasonable assumptions, the federal debt will be 4.1 to 5.6 percent of GDP in 2015 and 4.9 to 6.5 percent of GDP in 2021, even after many years at full employment.
    - Even at the low end of the range, debt-to-GDP will be 87 percent (the highest since 1947) and net interest payments would be 3.9 percent of GDP (higher than defense or non-defense discretionary spending).
- Even more worrisome, the situation is expected to deteriorate after 2021. The debt-to-GDP ratio will exceed the 1946 high of 108.6 in the early 2020's.
  - The major drivers are Medicare and Medicaid, as the baby boomers begin to retire and health care costs continue to escalate.

There Are Good Reasons to Care About Deficits/Debt

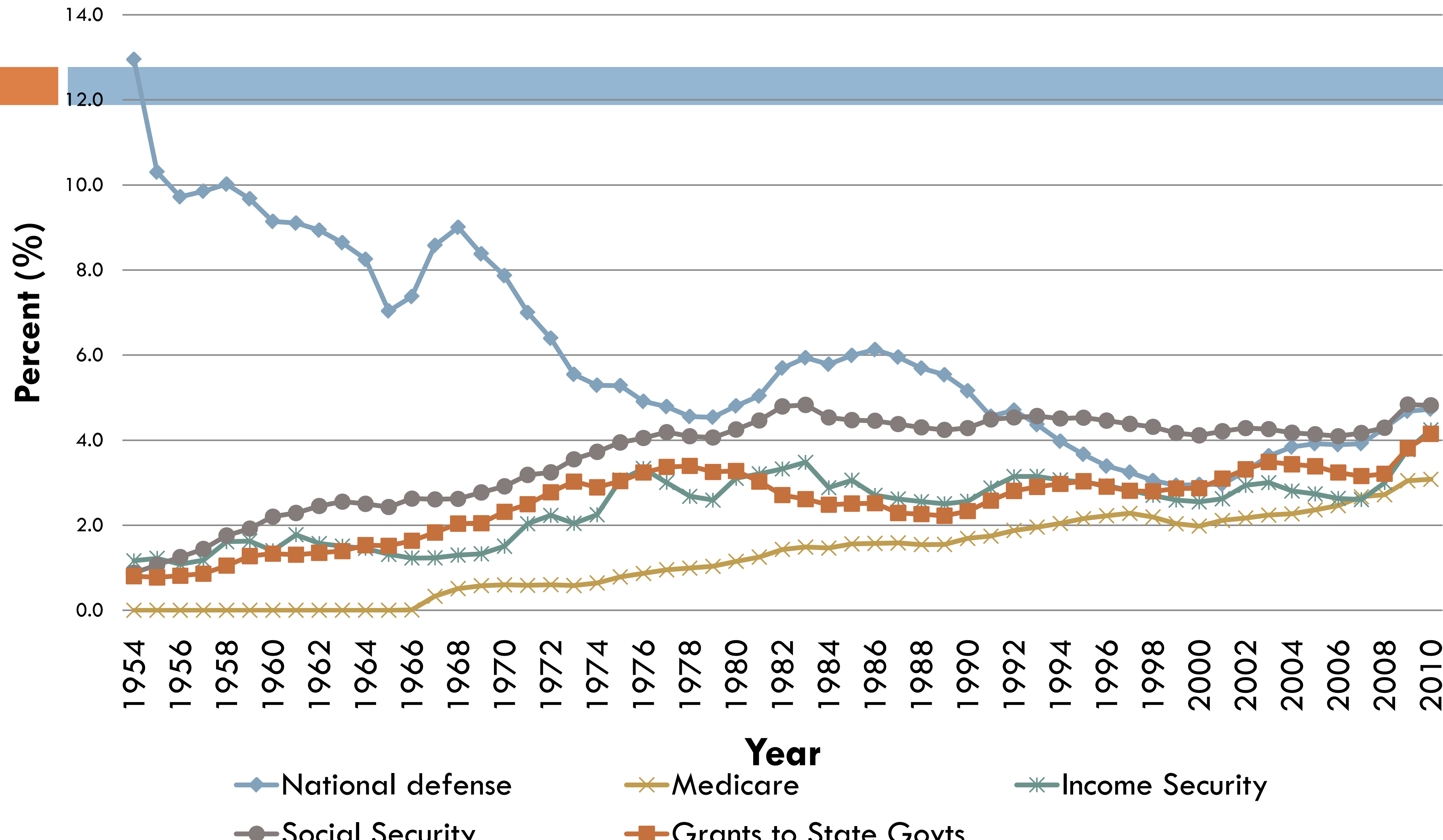
- Why do we care?
  - The problem is getting worse: even with full employment, the deficit as a share of GDP is expected to worsen substantially. Moreover, updated projections show deteriorating trends.
  - Deficits reduce national (public plus private) saving.
  - Lower national saving raises interest rates, reducing investment.
    - Capital inflows can mitigate this effect, but by raising claims on the domestic capital stock, future national income is reduced.
  - Large deficits also increase the possibility of sudden, catastrophic changes in interest rates, exchange rates, and/or movement of capital.

Spending



Data Source: Data of spending are from the Office of Management and Budget of the White House; GDP data are from the Bureau of Economic Analysis.

Figure 3-2. Government Spending on Selective Categories as a Percentage of GDP, 1954-2010



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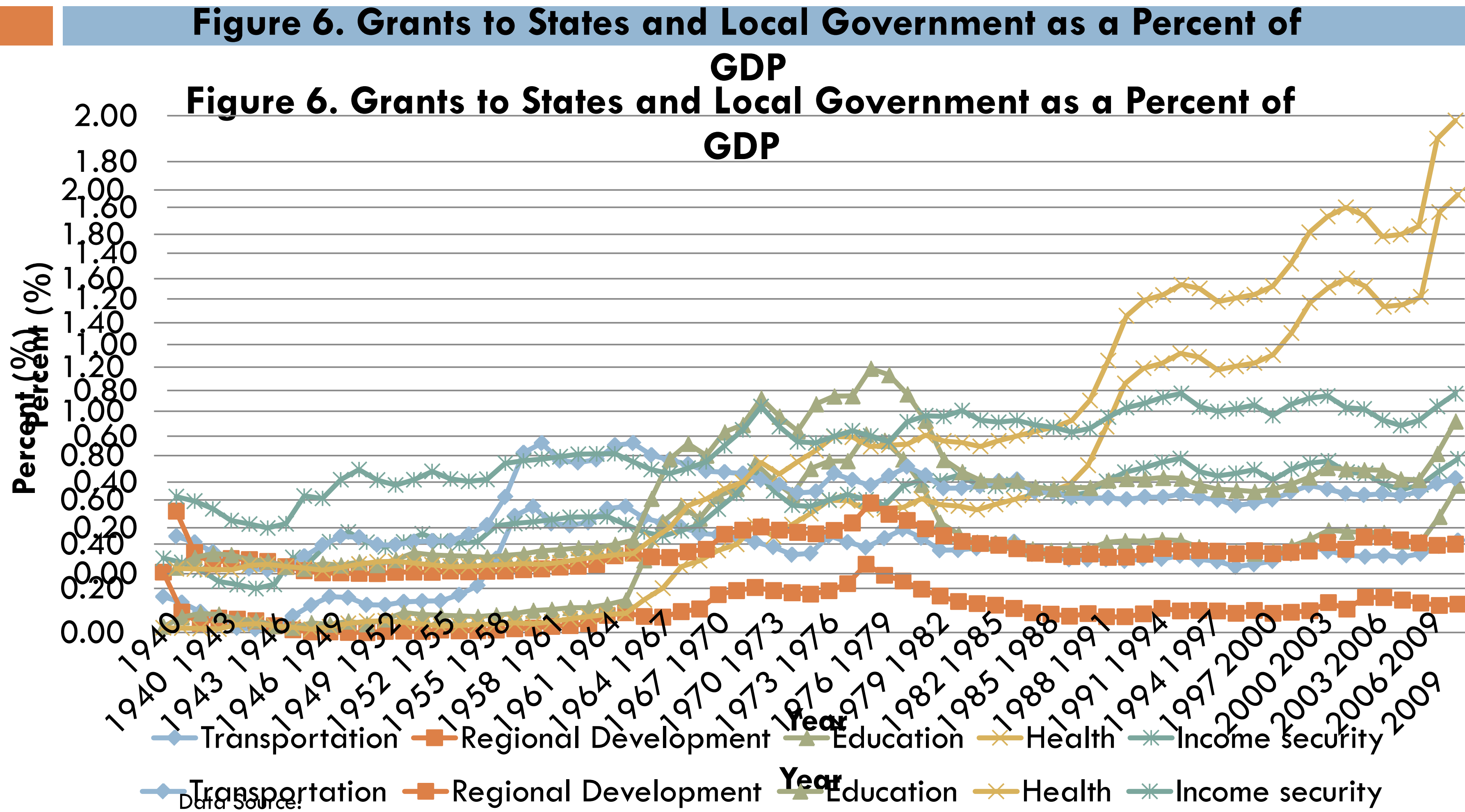
Federal Grants to State and Local Governments



Data Source:

1. Grants to states and local governments are from the Office of Management and Budget of the White House

2. GDP data are from the Bureau of Economic Analysis

Taxes

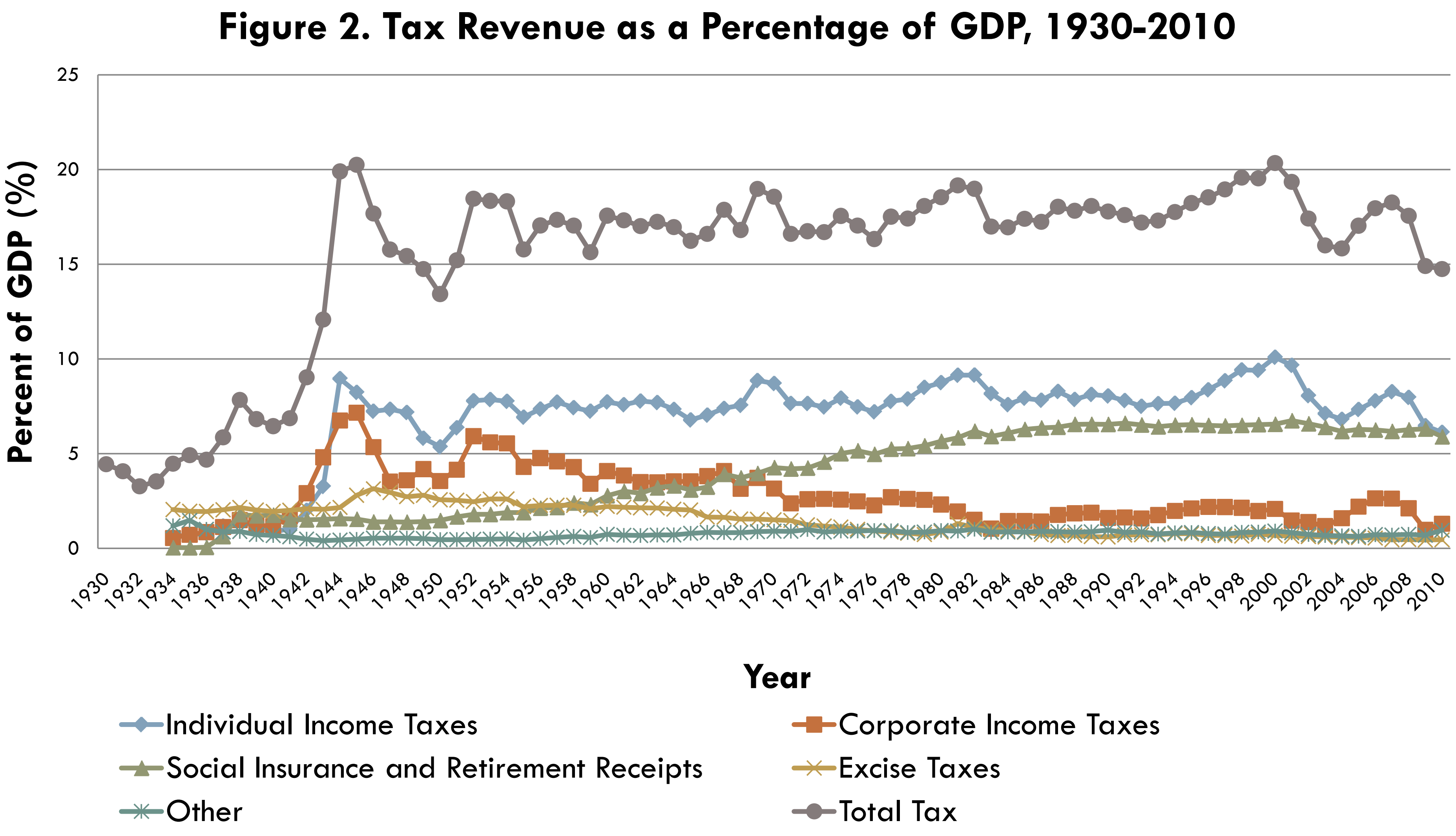


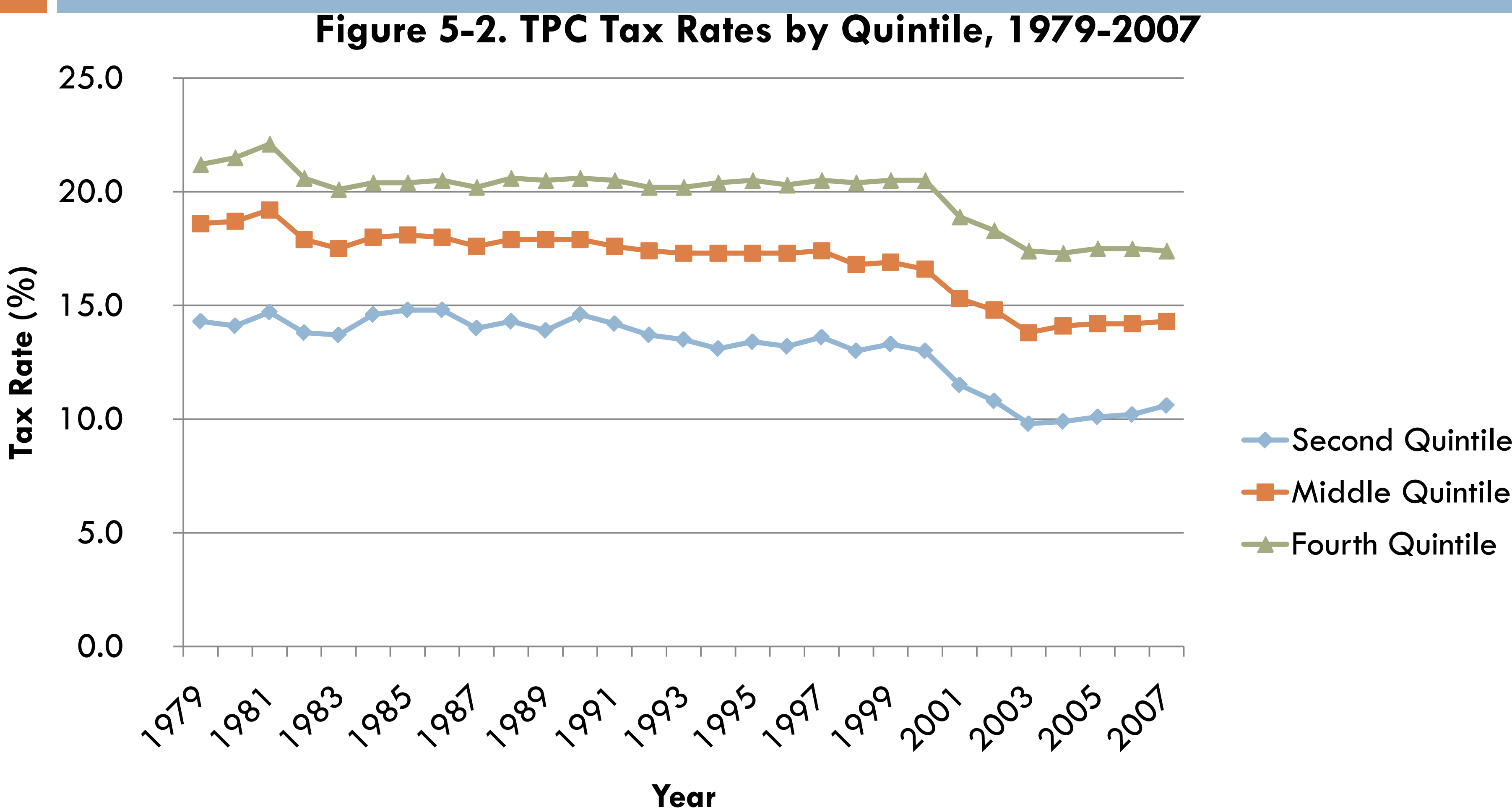
Figure 2. Tax Revenue as a Percentage of GDP, 1930-2010
Percent of GDP (%)
25
20
15
10
5
0
1930
1932
1934
1936
1938
1940
1942
1944
1946
1948
1950
1952
1954
1956
1958
1960
1962
1964
1966
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
Year
Individual Income Taxes
Corporate Income Taxes
Social Insurance and Retirement Receipts
Excise Taxes
Other
Total Tax

The Patterns of Spending and Taxes Are Revealing

- Spending has crept up – some is recession-related (such as UI). Some is related to executing (temporarily) two simultaneous wars.
  - Long-term health-related expenditures largely drive the structural pressure on spending.
- The tax series is remarkable.
  - *Federal taxes as a share of GDP are the lowest they have been since 1950!*
  - It is surprising to hear policy-makers express concerns about deficits, when they are unwilling to consider the revenue-side of fiscal policy.
    - There is clearly capacity to pay taxes.
      - Incomes of affluent households have increased sharply, yet their average tax rates have fallen.

Affluent Households Have Had a Very Good Two Decades

While Tax Rates Have Fallen For Affluent (and Other) Households

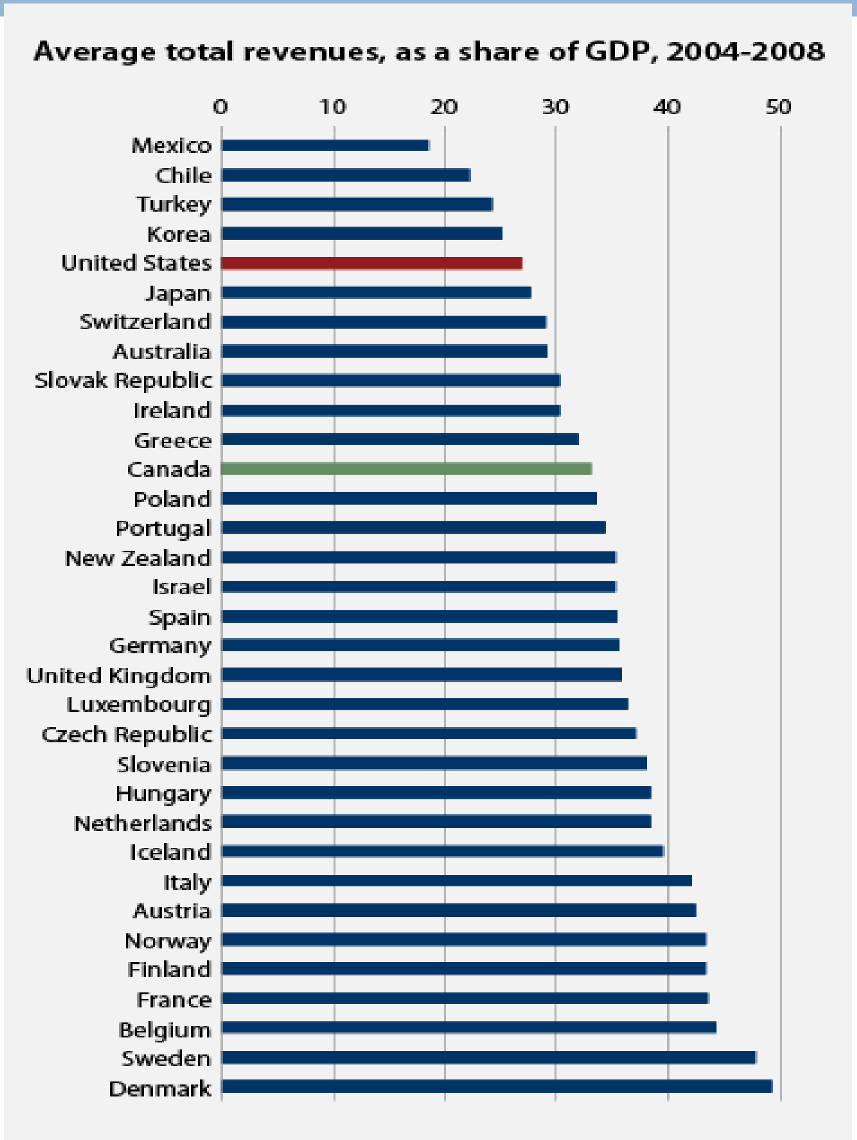


Source: The Urban Institute-Brookings Institution Tax Policy Center

Upshot

- The federal government provides substantial resources to states.
  - The federal government has the ability to raise more revenue without substantially jeopardizing economic performance (see, for example, the rest of the OECD).

The U.S. is Not a High-Tax Country



How Could Revenue Be Raised (and Help Relieve State Fiscal Problems)?

- Base broadening (trim tax expenditures).
  - The value of various preferences could be limited to 28 percent (or 15 percent) rather than a taxpayer's marginal tax rate. This would raise a lot of money.
  - Raise rates.
- The most intriguing from the S&L perspective: A Value-added tax (VAT).
  - 150 countries around the world have VATs, including *all* other OECD countries.
    - Efficient administratively. Taxes consumption so it is "pro-saving."
    - States could effectively piggyback on the VAT (as many do with the federal income tax), so it could be an efficient way to raise revenue for states.
- In this fiscal climate, however, VAT (or other substantial revenue sources) seem a remote solution to state fiscal problems.